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SUBJECT: TURKISH BUSINESS LEADERS EXPRESS OPTIMISM IN ISTANBUL DURING TREASURY VISIT

¶1. (SBU) Summary: On May 8 U.S. Department of Treasury officials, after a day of meetings in Ankara with high level government officials (septel), came to Istanbul to speak with bankers, economists and real sector representatives about Turkey,s economy. The consensus among the interlocutors was that Turkey will come out of the financial crisis in good shape, though not until 2010. The construction and financial sectors, anchored by a sound banking system, will lead the economy out of the wilderness. However, all agreed that the GOT must continue to liberalize and that the European Union (EU) and the International Monetary Fund (IMF) should anchor this process. Greater reform of the legal system, as well as greater transparency and emphasis on human capital (education) are all crucial to Turkey,s future. Turkey is economically stronger than the other countries in the region, but according to Ersin Ozince of Isbank, Turkey should be viewed as a part of the larger regional picture, albeit a very important part. (End summary).

¶2. (SBU) The Treasury group was headed by Deputy Assistant Secretary Andy Baukol, who was accompanied by a department director and a senior economist. Istanbul interlocutors included Ersin Ozince (CEO of Isbank and Chairman of the Turkish Banks Association); Ekrem Keskin (Secretary General of the Association); Ferit Sahenk (Chairman of Dogus Holding); Cevdet Akcay (lead economist at Yapi Kredi) and banker Ilker Domac of Citibank.

CHAIRMAN OZINCE EXPRESSES CONFIDENCE
¶3. (SBU) Istanbul is doing fine, Ersin Ozince declared, although Turkey,s culture and vision need to broaden. "We are not worried about the government. The business and financial community will force the government toward liberalization." An IMF deal would be nice, but Ozince is not overly concerned. There will be a "rational" IMF deal, but the IMF must also be flexible and view Turkey as part of the region. Such a deal, he believes, is more important politically than financially. In many ways he thinks that Turkey is head of its peers. "Why is Romania rated higher than Turkey?", he asks. "Fortis Bank (in Europe) went bust, but Fortis Turkey didn,t." He also noted that Iraqi and Chinese bankers are coming to Istanbul for seminars. Turkish banks are doing fine, though he noted non-performing loans (NPL,s) are up. Ozince mentioned that the Port of Mudanya on the Sea of Marmara has benefitted from serious upgrades and heavy infrastructure investment. The entire system will be electronically controlled. This port will do fine, though perhaps not all ports will do as well. An initial planned investment of USD 100 million will now take place in slower stages, but one third has already been invested. "There is no doubt the economic revival will occur," he declared. "The country and region have to grow." Ozince is bullish on the

Anatolian Tigers ("Gaziantep is innovative and entrepreneurial"), and he sees great potential for them in Northern Iraq and possibly Syria, particularly in textiles and machinery. Turkish firms made inroads into the CIS and North Africa, and now are trying to penetrate central Africa. Ozince concedes that after the crisis began there was loan contraction in Turkey and a higher rate of NPL,s, but the latter rose only from 3.5% to a present level of 4.6%. During the 2001 crisis, the NPL rate was more than 25%. High capital adequacy ratios in the banking sector allow more leverage. NPL,s remain low in conservative parts of the country such as Van.

¶4. (SBU) Ozince believes that construction, tourism and agriculture will help to improve employment. Tourism will be okay this year. Manufacturing is not the solution to unemployment, since it is generally not as labor intensive as other sectors. Construction potential in Istanbul is huge, with 60% of Istanbul,s building stock sub-standard and in need of renovation. Ozince claims that Turkey has the best construction expertise in the region, and noted that most airports in the region have been built by Turkish companies. In housing, mortgages represent only 5% of GDP, and the financial infrastructure for home lending and refinancing is still limited, since banking in Turkey is still fairly basic. This will provide a great growth opportunity -- housing is growing and will continue to grow.

SOCIAL AND LEGAL INFRASTRUCTURE MUST IMPROVE

¶5. (SBU) Ozince maintained that "Turkey must insure basic, conventional business and create a functional marketplace." The region needs good financial infrastructure, although there is a great deal of offshore capital. A better functioning legal system is essential to Turkey,s economic future, and Ozince along with some of the other interlocutors repeatedly stressed the need for an independent tax system and judicial reform. At present there is a large gray area in business, legal and accounting work, in part because there are few competent special courts in Turkey, and Ozince believes that the EU will continue to be a virtuous influence in this arena.

¶6. (SBU) Secretary General Keskin said the banking system is ready to extend credits to the private sector, but is still risk sensitive. Export unit growth is improving, but not price. Keskin views the public sector as a problem. Aggregate demand in Turkey must increase, but there is a growing fiscal deficit. The state should restructure expenditures, stop borrowing so much and generate more revenue. "Ideally Turkey should have a higher current account deficit (CAD), but one which is more financeable." Better revenue collection is necessary. Keskin describes Turkey,s capital markets as shallow, with fixed income borrowing dominated too much by the state, which leads to crowding out of private sector borrowing. The private sector wants to see better exports and higher incomes before borrowing and investing. On the plus side, Keskin concurs with the popular view that Turkish corporates have enormous amounts of offshore capital, some of which has come back to Turkey in recent months.

THE CENTRAL BANK SHOULD "MARKET" LOWER RATES

¶7. (SBU) Cevdet Akcay, lead economist for Yapi Kredi and one of Turkey,s most refreshing and provocative economic analysts, is more bullish on both the United States and Turkey than the consensus. He believes that credit markets are slowly improving in the United States, though he worries whether there will be greater demand for bank loans in the near term, and he thinks U.S. households will have to save more. Akcay believes that growth in Turkey is crucial, and sees a 3.2% contraction in growth this year followed by a 1.4% expansion in 2010. Trend lines show that industrial production may have troughed in late 2008 and early 2009, but industrial production accounts for only 20% of GDP, and Akcay hopes for a pickup in the services sector. Unemployment will remain a problem, but this is a lagging indicator. "2009 is

a lost year, but hopefully there will be a primary surplus in 2010," he noted. The Yapi Kredi economist is also optimistic on inflation and sees it coming down to 5.5% by this summer. He thinks the Central Bank has embarked on an "unannounced" policy of restructuring interest rates as inflationary expectations have come down, and believes the Central Bank should be more transparent and aggressively "market" a regime change in interest rates and inflation. In addition, he thinks that Central Bank reports are too long and academic. It,s okay to do academic research for a specific audience, says Akcay, but the daily reports for the general public should be "brief and convincing".

¶8. (SBU) Akcay sees the Turkish Lira (TL) in a range between 1.50 and 1.65, and scoffs at the notion that it will depreciate to 1.80 or worse. "We have run this scenario through our econometric models and it simply can,t happen." He thinks Turkey should have low interest rates and an exchange rate in the 1.60-1.65 range. Akcay sees only a 10-15% chance of no IMF deal this year, and thinks Turkey qualifies for an FCL (flexible credit line) although it seems headed for a stand-by agreement with the Fund. Turkey , he believes, needs the EU for political monitoring and the IMF for fiscal monitoring. "We need a fiscal roadmap, and I trust IMF officials more than GOT officials," he offers, though wryly adding that this is hardly a ringing endorsement. European bank exposure to emerging markets is extremely worrisome, Akcay believes, and we should really be worried about Europe. There is huge European exposure to emerging market debt, and "God help them if that implodes." Turkey will feel this if it occurs, but not like Europe.

TURKEY WANTS A PEACEFUL NEIGHBORHOOD

¶9. (SBU) Ferit Sahenk, Chairman of Dogus Holding, along with three senior executives in his group participated in a later discussion. Sahenk, a self-described "Kemalist and CHP supporter," acknowledges that times are changing. He joked that he recently sold a corporate division named after a family member, something his father would not have done. He stressed the need for vision in Turkey, vision which would

emphasize reform of the legal system, greater transparency and investment in education. Turkey will not be Iran, he declares. "Turkey wants a peaceful neighborhood." Echoing Chairman Ozince,s sentiments, Sahenk said Turkey should continue to "normalize" in the region. IMF funding is fiscally necessary, not just symbolic, but Turkey also needs to restructure to make the corporates more competitive. (See para 12 below).

¶10. (SBU) Ergun Ozen, president of Garanti Bankasi, noted that after the economic crisis in 2001, the banking sector became more transparent and most of its business was on balance sheet. This has helped the sector avoid many of the debacles that Western banking has experienced in recent months. Rate spreads will help profits in the first half of this year, but when that game ends in the second half volume will have to pick up based on economic growth. Garanti Bank forecasts a contraction in growth of 5-6% in 2009, and mild positive growth in 2010. Industrial production improved last month, but unemployment will be sticky and could go to 20% at the trough.

¶11. (SBU) Ozen stated that exports are still very important in Turkey, and European growth will probably be slow. Dollarization is rising as real interest rates decline. Since Ozen believes that inflation will be higher next year, he worries about the longer term trend for interest rates. "How does the Central Bank reverse monetary policy?" he asks. He also echoes Ekrem Keskin,s concern about the public sector crowding out private borrowing, since the government roll over rate could eventually exceed 100%, and public expenditures will continue to grow. Ozen thinks a 4% budget deficit to GDP ratio would be reasonable.

¶12. (SBU) Sahenk thinks that Turkish corporates must be more efficient, and emphasized the need for investment in

intellectual capital. Risk management and feasibility studies are not conducted at a high level in Turkey, he noted. "We have engineers but not site managers." Government should not be subsidizing the corporate sector, he argued. Sahenk feels strongly that education in Turkey must be democratized, and he states emphatically that education is America,s greatest export. If the United States and Turkey enthusiastically continue to promote student visas, both countries will benefit. "And," he implored his Treasury guests, "please tell your government to resist trade protectionism at all costs."

A NOTE OF CAUTION FROM CITIBANK

¶13. (SBU) Ilker Domac of Citibank was more cautious than the other interlocutors on Turkey's near-term prospects. Domac worries that the government is not putting its fiscal house in order, and therefore cannot continue to cut interest rates, since large corporations in Turkey have a big open foreign exchange (FX) position and continued Central Bank easing will lead to currency depreciation. In addition, with a roll over rate of public debt of close to 100% he fears that government will crowd out private sector borrowing just as the private sector's external payment schedule is about to increase. Domac views an IMF deal as essential to Turkey's fiscal and economic stability, and ideally would like to see an IMF program that restrains current expenditures, especially transfers and discretionary spending. The Citibank official thinks that growth this year will contract by 4% and that the budget deficit will go to 5% of GDP. He believes that in 2010 Turkey needs a primary deficit of at least 2% in order to keep its debt at manageable levels.

¶14. (SBU) (Comment). Noteworthy in these discussions was that the mixture of bankers, economists and real sector executives was basically optimistic about Turkey,s economic future, with obvious caveats such as those raised by Ilker Domac. The general theme of these meetings was that if and when the global situation stabilizes, Turkey will be well positioned to grow. Consistent with this was the view that the United States remains Turkey's strategic partner, with the EU and the IMF as crucial institutional monitors. "Stabilize Turkey and you stabilize the region," Ozince notes.
Wiener